Compliance Corner

— By Thomas V. D'Ambrosio*

Dodd-Frank Derivative Reform and Investment Advisers

Introduction

The Dodd-Frank Act was enacted into law on July 21, 2010. Title VII of the Dodd-Frank Act, entitled the "Wall Street Transparency and Accountability Act of 2010," contains the statutory provisions reforming the over-the-counter (OTC) derivatives market. Traditionally the OTC derivatives market was a bilateral and largely opaque market. The Dodd-Frank Act imposes clearing, exchange trading, capital, margin, registration, reporting, recordkeeping, business conduct and position limit requirements (among others) upon the OTC derivatives market and certain of its participants. Congress delegated authority to the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC) to promulgate rules in order to implement the directives of the Dodd-Frank Act. As of the date of this article, however, neither the CFTC nor the SEC has fully completed their required rule-making. Nevertheless, some rules are final, if not yet effective, and are certain to impact investment advisers who use OTC derivatives on behalf of clients. This article will focus on some of those rules.

Business Conduct

Fulfilling a statutory mandate, the CFTC has adopted business conduct rules which will apply to dealers and major participants in the swaps markets. As of the date of this article, the SEC has not adopted final business conduct rules, although by statute they are required to do so and there is a general expectation that the SEC's rules will be substantially similar to the CFTC's rules. While not yet effective, the CFTC's business conduct rules contain numerous burdensome provisions for dealers and major participants. Even though the business conduct rules do not apply to investment advisers, the rules will affect the operations of investment advisers and how investment advisers interact with dealers and major participants on behalf of clients.

Under the CFTC's business conduct rules, a dealer must know its counterparty, including the true name and owner of the counterparty and any guarantors and control persons with respect to the counterparty. Before offering or entering into a swap transaction, both dealers and major participants must determine if a counterparty is an "eligible contract participant" and, therefore, eligible to participate in the swaps market. Dealers recommending a swap strategy must understand the risks and rewards of the swap strategy and reasonably believe that it is suitable for the counterparty. However, the dealer is able to take advantage of a safe harbor if it determines that the counterparty or its agent (*e.g.,* the investment adviser) is capable of independently evaluating the risks of the swap. Because the dealer is entitled to use written representations in making such determination, investment advisers should expect that they will be asked to sign representations relating to their capability of analyzing the applicable swap on behalf of the client.

Additionally, dealers and major participants must determine if the counterparty is a "special entity." Special entities include federal agencies, states, state agencies, cities, counties, municipalities, their instrumentalities, employee benefit plans, governmental plans and endowments. Special entities receive extra protections under the Dodd-Frank Act. When a dealer recommends a swap to a special entity or otherwise acts as an advisor to a special entity, it must act in the best interests of the special entity. Such level of fiduciary duty is not necessary, however, if the special entity has an ERISA fiduciary, and the special entity and the fiduciary are not relying on the dealer. In order to take advantage of this safe harbor, dealers will require investment advisers to make appropriate representations. When a dealer acts as a counterparty (as opposed to acting as an advisor) to a special entity, it still must ensure that the special entity is being advised by an ERISA fiduciary or another representative that is, among other things, independent, knowledgeable and under a duty to act in the best interests of the special entity. In this case as well, the dealer will satisfy its burden partially through the use of written representations.

A representative of a special entity is deemed to be independent of the relevant dealer or major participant if:

(1) the representative is not and, within one year of representing the special entity, was not an associated person of the dealer or major participant,

(2) there is no principal relationship

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between the representative of the special entity and the dealer or major participant,

(3) the representative provides timely and effective disclosures to the special entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the special entity,

(4) the representative complies with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest,

(5) the representative is not directly or indirectly controlled, controlled by or under common control with the dealer or major participant, and

(6) the dealer or major participant did not refer, recommend or introduce the representative to the special entity within one year of the representative's representation of the special entity in connection with the applicable swap.

Importantly, there is a safe harbor for the dealer or major participant whereby it will be deemed to have a reasonable basis to believe that the special entity has a representative that satisfies the foregoing requirements if certain representations are made. First, the special entity will have to represent that it has complied in good faith with written policies and procedures designed to ensure that it has selected a representative that satisfies the foregoing requirements and that such policies and procedures provide for the ongoing monitoring of the performance of the representative. Second, the representative (*i.e.,* the investment adviser) will have to represent to the special entity, dealer and major participant that it has policies and procedures reasonably designed to ensure that it satisfies the foregoing requirements, that it meets the foregoing independence test, and that it is legally obligated to comply with the forgoing requirements. A second safe harbor also exists if the special entity provides the investment adviser's name and contact information in writing to the dealer or major participant and represents that the representative is a fiduciary as defined under ERISA. Those investment advisers who are not ERISA fiduciaries will have more work to do for each swap transaction so that the dealer or major participant will be able to take advantage of the first safe harbor.

Dealers and major participants will be under a duty to make robust risk disclosures prior to effecting swap transactions. Those disclosures must identify material market, credit, liquidity, foreign currency, legal and operational risks as well as material incentives and conflicts of interest. On behalf of their clients, investment advisers will have to review and understand the content of such disclosures in order to satisfy the standard of care typically set forth in the investment management agreement with the client.

Upon request, dealers must prepare a scenario analysis for each swap transaction which is designed to assess potential exposures under a range of assumptions for the swap transaction. Additionally, dealers will have to permit counterparties (including investment advisers acting on behalf of counterparties) to consult on the design of the scenario analysis. Investment advisers will have to determine whether to request such an analysis and whether to consult on the design of the scenario analysis.

Dealers and majors must provide a daily mark for a swap transaction for uncleared swap transactions and must notify a counterparty of the right to receive a daily mark from a derivative clearing organization upon request. Investment advisers will have to develop the operational capabilities to request and monitor those marks on behalf of clients.

Clearing

The Dodd Frank Act anticipates that many OTC derivative transactions will be subject to mandatory clearing requirements. For swaps required to be cleared, a dealer or major participant must notify the counterparty (or its investment adviser) that the counterparty has the sole right to select the derivatives clearing organization at which the swap will be cleared. For swaps that are not subject to mandatory clearing, the dealer or major participant must notify the counterparty (or its investment adviser) that the counterparty has the right to have the swap transaction cleared and select the derivatives clearing organization at which it will be cleared. Investment advisers will have to consider how to make the foregoing elections on behalf of clients. Investment advisers will also have to consider the way in which clearing changes the economics of a swap transaction and the netting and insolvency aspects of a swap transaction. For example, cleared swaps will have a mandatory initial margin requirement which is not negotiable. Also, it will be difficult, if not impossible, to net cleared swap transactions with uncleared swap transactions, a fact which may cause the risk profile of a portfolio to change in unanticipated ways. Investment advisers will have to consider all of these elements. Lastly, when selecting the derivatives clearing organization at which to clear a swap on behalf of the client, the investment adviser will be expected to understand how the clearing organization operates, its sources of liquidity and the nature of the financial commitments of its members in the event of a failure of a member or a customer of a member.

Documentation

Investment advisers should expect that the documentation governing their swap transactions will change. Not only will dealers and major participants require more robust representations from investment advisers in connection with swap transactions as mentioned above, but the traditional International Swaps and Derivatives Association (ISDA) documentation package will have to

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be modified to address the mandated clearing, collateral and risk disclosure requirements of the Dodd-Frank Act. Recognizing that amending outstanding derivative documentation will require a great deal of effort, ISDA is currently preparing documentation which will address some of these issues in the form of generic and product specific risk disclosures and a form bilateral protocol. Additionally, ISDA and the Futures Industry Association have already produced draft form agreements relating to the treatment of cleared derivatives transactions. Finally, ISDA is working with Markit to develop a technology-based solution to enable counterparties to amend their derivative documentation for the purpose of facilitating compliance with the Dodd-Frank Act. Investment advisers should familiarize themselves with these new documents, disclosures, protocols and technologies as they become available.

Costs of compliance

The requirements imposed upon dealers and major participants by the Dodd-Frank Act will increase the cost to those entities of providing swaps to end users. It is unclear, at present, as to how much of that increased cost will be passed through to the end user or retained by the dealer or major participant. However, it is reasonable to expect that certain transactions may suffer a change in economics when all of the Dodd-Frank Act rules and regulations are finalized and effective, and investment advisers will have to carefully consider the continued use of such derivatives in their portfolios as well as possible alternatives.

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CFTC Staff Issues No-Action Letter Extending CPO/CTA Registration Deadline for New Pools to December 31, 2012

On July 13, the staff of the CFTC's Division of Swap Dealer and Intermediary Oversight released a no-action letter dated July 13 to the Investment Adviser Association and other industry groups, including the Managed Funds Association, the Alternative Investment Management Association, and the Investment Company Institute, providing no-action relief for commodity pool operators (CPOs) and commodity trading advisors (CTAs) that were exempt or excluded from registration prior to April 24, 2012 but, because of recent amendments to CFTC Regulations 4.13 and 4.5, now need to register and satisfy compliance obligations. Earlier this year, the IAA submitted a letter to the CFTC requesting an extension of the compliance date for CPO and CTA registration with respect to new commodity pools launched after the April 24, 2012 compliance date.

In the no-action letter, CFTC staff stated it would not take enforcement action against CPOs or CTAs for commodity pools launched after the issuance of the July 13, 2012 letter, as long as the CPOs and CTAs register by December 31, 2012 if: (1) the CPO or CTA files a notice with the CFTC to take advantage of the no-action relief, and (2) the CPO and CTA comply with certain conditions outlined in the no-action letter (*i.e.,* interests in the pool are exempt from registration under the Securities Act of 1933 and are offered and sold without marketing to the public of the U.S., and the CPO reasonably believes, at the time of investment, that (a) each natural person participant (including the person's self-directed employee benefit plan, if any) is a "qualified eligible person" (QEP); and (b) each non-natural person participant is a QEP, or an "accredited investor," as that term is defined under the Securities Act.)

The CFTC also granted no-action relief where each pool for which the CPO claims relief under the registration compliance date exception is a registered investment company under the Investment Company Act of 1940.

The CFTC staff also granted no-action relief where the CTA submits a claim to take advantage of the relief, and complies with the following conditions: (1) the CTA claims relief from registration as a CPO under the no-action relief and its commodity interest trading advice is directed solely to, and for the sole use of, the pools that it operates; or (2) the CTA's commodity interest trading advice is directed solely to, and for the sole use of, pools operated by CPOs who claim relief from CPO registration under Regulation 4.13(a)(1), (a)(2), (a)(3), (a)(4), 4.5, or under no-action relief described in the CFTC's July 13 letter.

The IAA had also requested in our comment letter that the CFTC extend the compliance date for including "swaps" within the CPO trading

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